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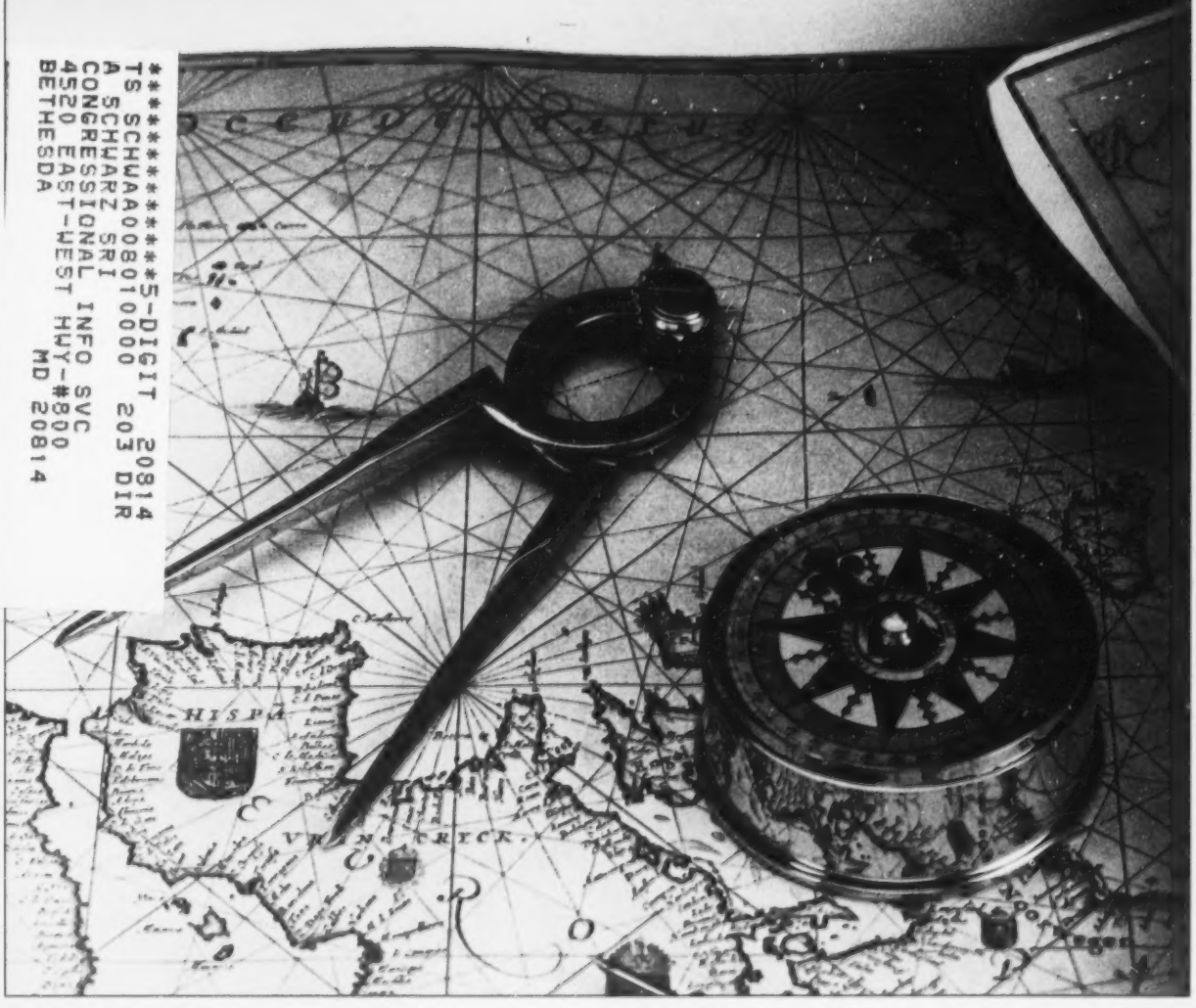
TRUSTS & ESTATES®
ESTATE PLANNING & ADMINISTRATION A Publication of Communication Channels Inc. SEPTEMBER 1992

Plotting The Course Of Change In The Industry

The Family Limited Partnership- Centerpiece Of An Advanced Plan



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TRUSTS & ESTATES

Volume 131, No. 9 Estate Planning and Administration since 1904 SEPTEMBER 1992

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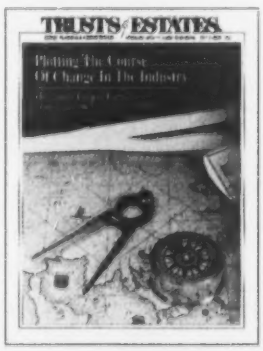
Whether you are plotting a new course for your estate planning practice or trust department or struggling to maintain your present direction there are some industry trends of which you should be aware. Photo courtesy of Jos. Palmieri, Dover, NJ.



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Editor's Notes

Early Effort To Understand Helps Ease Transition

One needs only to scan the pages of recent issues of *The Wall Street Journal* and the *American Banker* to realize that the complexion of banking and the practice of law, in general, is changing and that the practice of trust and estate planning, specifically, is in a great state of transition.

Headlines such as "Trust Revenues Growing At Slower Pace Than In '80s", "Merrill Lynch Stepping Up Effort To Lure Personal Trust Business", "Mellon And Giant French Bank Team Up To Offer Trust Services", and "Law Firms Are Laying Off Partners" are indicative of just some of the diverse adjustments which are occurring within the field. These alterations to the business which are happening today will set the tone for growth and expansion in personal trust services well into the next century.

On the banker's side, trust officers are witnessing the merger of private and trust banking and the alignment of like products, the consolidation of banks, the increased use of mutual funds, the growth of independent trust companies, expanded non-bank competition, erosion of the Glass-Stegall Act, new fee structures, and expansion of "traditional" trust services.

On the attorney's side, estate planning practitioners must cope with constant revisions to the laws and rules, the increased liability for malpractice, the increasing diversity of clients, the growing desirability of avoiding probate through the use of trusts as well as the use of trusts for non-tax reasons, and the changing economics of the practice.

This month, we open up some of these topics for discussion. And, although the debate on these subjects may shift as we approach the year 2000, at least we can say that we recognized the impending trends and made an early effort to understand the implications for ourselves and our clients.

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BPA

Changes In The Industry

Bank Mutual Funds: Growth Vehicle Of The '90s

As banks approach the 21st century, they will find a mutual fund industry no longer top-heavy with money market funds

By **CHARLES B. LANDRETH**
PNC Financial Corp.
Wilmington, DE

The year was 1972. A high-rise called Watergate emerged from obscurity and forever became synonymous with political chicanery and governmental crisis. Irish Republican Army terrorism intensified in Ulster and the British government assumed direct rule over the province. The movie "The Godfather" grossed nearly $88 million. Commercial loan rates were about 6 percent, unemployment stood at 5.6 percent and the United States was still two years away from the Arab oil embargo that would send shock waves through the economy.

The Closed-End Fund

The year also witnessed the quiet birth of Independence Square Income Securities (ISIS). Although not as memorable as the other events of 1972, the introduction of this bond fund was important in the financial community. The ISIS offering, which closed on Feb. 22, 1972, marked the first time that a bank — in this case, Provident National Bank, which since that time has become an affiliate of PNC Financial Corp. — acted as investment advisor to a closed-end mutual fund. ISIS, in short, brought the banking industry into the mutual fund business. Today, banks are playing an increasingly significant role in that business, a role that will continue to expand as we approach the year 2000.

Mutual Fund Growth

As of March 31, 1992, banks managed $142.5 billion, or 10 percent, of the $1.428 trillion in U.S. mutual fund assets, up from less than 5 percent in 1987, according to Lipper Analytical Services, Inc. Of the $142.5 billion in bank-managed mutual funds, $112.6 billion, or 79 percent, are money-market mutual funds. But banks' share of the equity and fixed-income funds also has risen dramatically in the last five years as well.

Assets of bank-related equity funds have grown nearly sevenfold since 1987, to $14 billion, while assets of bank-managed fixed-income funds have increased tenfold, to $10.4 billion. (See Figure 1.) What's more, the total number of bank-managed funds now stands at 733, more than triple the number that existed in 1987. (See Figure 2.)

Despite the continued restrictions imposed by the Glass-Steagall Act, which bar banks from competing in the mutual fund business on equal footing with brokerage firms, about 100 of the nation's largest trust banks now boast proprietary funds. Why do these banks find mutual funds attractive? They are appealing for the two fundamental reasons that drive any organization to develop new products: to take advantage of an opportunity for profitability and to satisfy customer needs. Indeed, mutual funds are a natural extension of the money management services that trust departments have been engaged in for many decades. But mutual funds offer a key advantage over traditional trust products such as common funds and collective funds: they are convenient and offer a greater number of investment options. Customers do not have to establish a trust relationship with a bank in order to invest in mutual funds. What is more, investors can readily follow the performance of mutual funds each day on the financial pages.

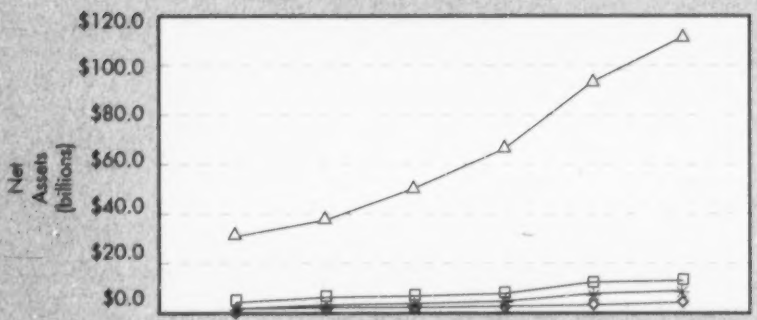
Moreover, customers have come to recognize that bank-advised mutual funds produce highly competitive returns. Bank trust departments have clearly demonstrated leadership in managing investments. A series of studies in recent years by CDA Technologies Inc. has shown that, over the long term, the portfolio managers in trust departments out-perform brokerage firms, insurance companies and investment ad-

visors. In addition, they do it consistently while incurring less risk for their clients' portfolios.

CDA's most recent study, released in February 1992, found that for the 10-year period ending Dec. 31, 1991, banks posted a 17 percent annualized rate of return in managing common stocks. Banks were followed by insurance companies (16.9 percent), investment advisors (16.6 percent) and mutual funds (15 percent). The study also found that for the three- and five-year periods ending last Dec. 31, trust departments were second only to investment advisors in the rates of return they earned for their customers. (See Figure 3.) It is important to point out, though, that when the performances of the four investment-management groups were statistically adjusted for risk, banks turned in the best performance for all three time periods covered by the study.

FIGURE 1

Total Bank-Related Fund Universe Assets for Various Time Periods 1987-1991



Year End:	1987	1988	1989	1990	1991	3/31/92
Money Market	$31.4	$37.5	$50.4	$66.8	$95.2	$112.6
Equity	$2.2	$3.3	$5.4	$6.4	$12.6	$14.0
Fixed Income	$0.9	$1.8	$2.6	$3.9	$8.9	$10.4
Tax-Free bond	$0.9	$1.2	$1.8	$2.8	$4.9	$5.5
Total Bank	$35.4	$43.8	$60.2	$79.9	$121.6	$142.5
Total Industry	$768.4	$812.6	$855.3	$1018.4	$1185.8	$1428.7

△ Money Market □ Equity ✳ Fixed Income ◇ Tax-Free Bond

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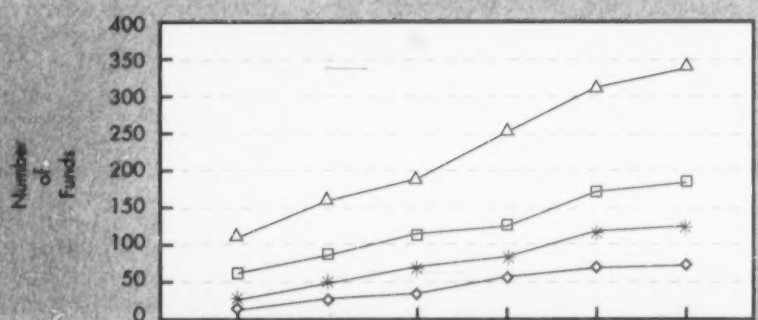
FIGURE 2

Total Bank-Related Fund Universe Number of Funds/Classes for Various Time Periods 1987 - 1991



Year End:	1987	1988	1989	1990	1991	3/31/92
Money Market	109	154	191	256	316	342
Equity	58	86	107	132	172	187
Fixed Income	26	48	67	84	116	127
Tax-Free bond	20	32	39	55	71	77

△ Money Market □ Equity ✳ Fixed Income ◇ Tax-Free Bond

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New Growth

Where will the growth of bank mutual funds come from over the next 10 years? After 20 years of growth, most of it in the money-market mutual funds, the prospects for finding new markets for cash investments has dimmed for the most part. One particularly bright spot, however, is corporate cash management. Company treasurers have found money-market mutual funds attractive because the returns of an actively managed pool of securities can take advantage of interest rate anomalies and provide returns that are greater than those offered by individual instruments. What's more, professionally managed funds save company treasurers the considerable time and effort required to research and choose individual securities.

By and large, though, the opportunities for banks to achieve the kind of growth in money-market mutual funds that they have enjoyed in the past two decades have passed. If bank-managed mutual funds are to achieve significant new growth throughout the 1990s and into the 21st century, that growth will be found in fluctuating net asset value funds — stock and bond funds.

As the CDA Technologies studies have shown, trust departments have amply demonstrated their money-management capabilities, so it is not difficult to convince customers that they can obtain competitive returns through bank-advised mutual funds. Stock and bond funds are more attractive to banks because they are a significantly greater source of fee income. Another key reason why stock and bond funds hold such great promise for banks can be found in the nation's shifting demographic picture. As the nation's population ages, millions of baby boomers will

begin to save more and spend less, opening up a market of billions in new capital for institutions that provide money management services. Some banks have begun to make inroads into the market for 401(k) retirement savings plans, while others are hungrily eyeing that market.

Fortunately, banks already possess the distribution channels necessary to procure a larger share of the burgeoning market for equity and fixed-income funds. They can, for instance, market these funds to existing trust customers. Or they can use mutual funds as either substitutes or supplements to existing common and collective funds in client portfolios. More broadly, banks can arrange with third-party securities vendors to distribute the funds through the banks' existing branch networks, use corporate calling officers to generate customer interest, or enter into joint ventures with local brokerage firms to sell funds. As the law stands now, of course, a securities firm must underwrite and sell bank-managed funds. But a bank that is strongly committed to mutual funds can still find ways to gain a foothold in the market and strengthen it. For example, the affiliates of PNC Financial are using the third-party approach to distribute mutual funds to their retail customers.

Clearly, the large majority of U.S. banks are not currently making mutual funds available to their customers. And, it is likely that many will decide in years to come — even if the walls of Glass-Steagall are finally breached entirely — that distributing their own mutual funds is not for them.

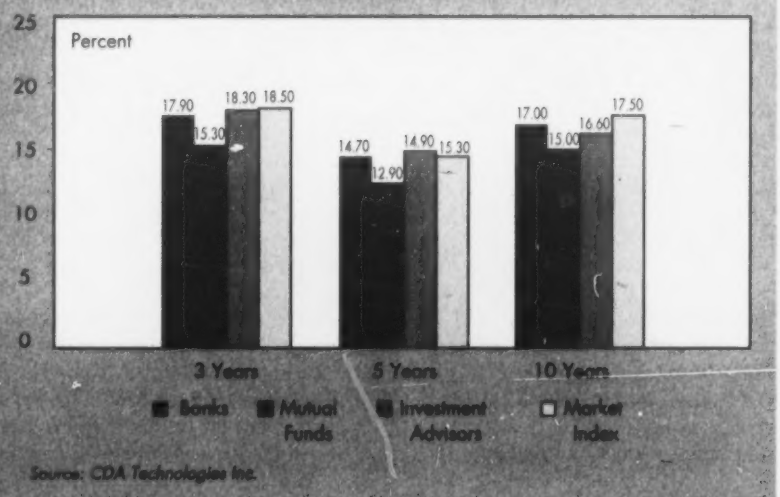
One reason why most banks do not manage their own mutual funds is that they lack the assets to do it properly. Institutions with trust assets of less than, say, $1 billion find it virtually impossible to offer a broad array of products; it is a rule of thumb that the size of each portfolio must be $200 million to $250 million to generate sufficient profit. Moreover, many existing trust clients with large accounts will shun mutual funds and continue to demand individual portfolio management.

"Wrapper" Funds

Banks that find themselves in this position, yet still wish to make more investment products available to customers, have one promising avenue open to them — so-called "wrapper" funds. Using this approach, small- to mid-size banks can augment their own products by offering customers other funds that are managed by other banks. (These products are called wrapper funds because the title page of the fund's prospectus, which "wraps" around the text of the prospectus, carries the name of the bank that is marketing the funds; only after reading the text does the

FIGURE 3

Equity
Annualized Rates Of Return
For Periods Ended 12/31/91



Source: CDA Technologies Inc.

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potential customer discover the fund manager is another institution.)

Wrapper funds allow a bank to close down their common and collective funds and convert their customers to mutual funds. This step not only opens up additional investment opportunities to customers, it strengthens the sales effort of the bank promoting the wrapper funds. Common trust fund managers, their need to research and manage investments now reduced, can turn their expertise to sales, explaining the advantages of mutual funds to existing customers and developing new prospects. In sum, a bank marketing wrapper funds can strengthen its sales force — there is no one better equipped to sing the praises of mutual funds than an investment expert — reduce costs and embark on an ambitious program to increase revenues.

More broadly, strategic alliances can play a pivotal role in the bank mutual fund business. As long as Glass-Steagall prohibits banks from distributing funds directly, alliances with broker-dealers — and with other banks — should not be viewed as nagging roadblocks but as necessary vehicles to carry banks down the right profit paths.

Sales — A Key To Success

The importance of sales and marketing in the bank mutual fund business cannot be overstated. Even those banks that do have sufficient trust assets to manage mutual funds, as well as track records of investment performance, sometimes face an impediment of their own making — lack of vigorous marketing efforts. In 1988, Lipper Analytical took part in a survey that found that most banks were predominantly interested in managing, not selling, mutual funds.

In a recent issue of *ABA Banking Journal*, A. Michael Lipper, president of the fund analysis and consulting firm that carries his name, wrote: "Theoretically, investment management is more important than distribution. But in reality, sales and marketing skills are crucial to success, no matter how good the investment management. The performance data suggests that banks can compete as mutual fund investment managers. The remaining question is whether they can compete as business managers. The answer isn't likely to be affirmative as long as bankers continue to view the mutual fund business as a collection of functions — investment advisor, administrator, sponsor, distributor — rather than a single enterprise with a strong sales focus."

The European Model

As the U.S. banking industry moves ever more closely to the model of universal banking, the European experience provides a glimpse of just how large a part American banks might be able to play in the mutual fund business in the decades ahead. The European mutual fund industry is made up of 765 fund complexes, 5,262 open-end funds and almost $600 billion in assets, according to Lipper Analytical. These figures exclude all closed-end funds, all German special funds for insurance companies and the popular Funds Common du Placement in France, so they represent only about half the industry.

The market is dominated by banks and bank groups, and most of the assets are not in money-market funds. In the United Kingdom, for example, 96 percent of fund assets are in equities; in Germany, 69 percent of assets are in bond funds; and in Italy, 46.4 percent are in bond funds. In Europe, the institutional-only funds are insignificant players, and the fund business is expanding.

The U.S. Outlook

Whither Glass-Steagall? For the past two decades, banks have been predicting the imminent demise of the 60-year-old law. But the law is still with us, and it is impossible to say with any degree of certainty when it will, finally, be laid to rest. But eventually, Glass-Steagall will dissipate and U.S. banks will once again assume the position they held before the Great Depression — financial supermarkets on the European model that provide a complete line of financial services to customers.

In the meantime, the mutual fund industry will continue to grow and the banking industry will continue to evolve. The $1.428 trillion mutual fund industry will probably reach $3.5 trillion by the year 2000 and $5 trillion by the year 2010. Right now, there are 12,000 banks; by 2000, this number will be trimmed to about 8,000. Today there are 2,500 thrifts; by 2000, there could be fewer than 1,000. At last count, there were 400 mutual fund complexes and 375 brokerage firms. By 2000, we can expect to see the number of complexes reach 500, a 25 percent increase, but brokerages may only rise by 10 percent.

Today, there are 36 million mutual fund shareholders, but since this figure includes double, triple and quadruple counting, the actual number of people who own mutual funds is much less than 36 million. It may be that only 10 percent of the nation's 100 million adults own shares in funds. Even though the field of distribution points could shrink in years to come, the players will grow in financial strength. This development will place increased emphasis on profit margins, marketing and distribution.

A Tremendous Opportunity

The banking industry has a tremendous opportunity throughout the 1990s. All banks must have a mutual fund strategy in our overbanked country, even if the strategy means not managing mutual funds directly but using the wrapper approach. U.S. banks can model themselves after the Europeans, but U.S. banks face one hurdle the Europeans do not: the Europeans "own" their customers as a result of their long-standing ability to offer a full complement of financial products. In the United States, individuals, if not institutions, are moving away from banks, using money funds instead of checking accounts and using firms such as Ford Motor Credit or General Motors Acceptance Corp. to buy cars instead of banks' retail lending arms. Put simply, bank retail customers are going elsewhere. Hence, banks will have to rely on more than their branch systems and find other ways to sell mutual funds.

They will use direct mail, telephone solicitation and automated teller machines. What is more, they will find homes for their funds through 401(k) programs, which now constitute about 10 percent of a $10 trillion financial services market and are projected to grow to 15 percent by 2000. Mutual fund investing in 401(k) plans should prove an important market for banks to crack since these investments involve the core of banks' investment expertise — stock and bond funds. Banks' supe-

rior investment management performance, shown by the CDA Technologies studies, will help differentiate banks from their competitors.

In addition, personal financial services is an industry producing about $40 billion a year in new revenue, but much of that money is ending up in the hands of brokerages, insurance companies and investment advisors. Banks, if they act aggressively, can use mutual funds to capture a larger share of that market. Now, there is no question this will be a tough row to hoe. Provident National Bank, for example, enjoys 24 percent of the trust business in the Philadelphia area but only 3 percent of the total financial services market. Still, the potential is enormous. And, one advantage that Provident and other banks have going for them is trust. A 1989 survey by Phoenix-Hecht and the Gallup Organization rated banks No. 1 when customers were asked where they would "definitely consider obtaining a mutual fund." (See Figure 4.)

Another major impetus for mutual fund growth is the current low interest rate environment, which can be expected to prevail for at least the next several years. In fact, PNC predicts a "2, 4, 6" scenario for 1995 — 2 percent inflation, 4 percent short-term rates and 6 percent long-term rates. An era of declining rates paid on certificates of deposit gives banks an opportunity to suggest that customers use mutual funds.

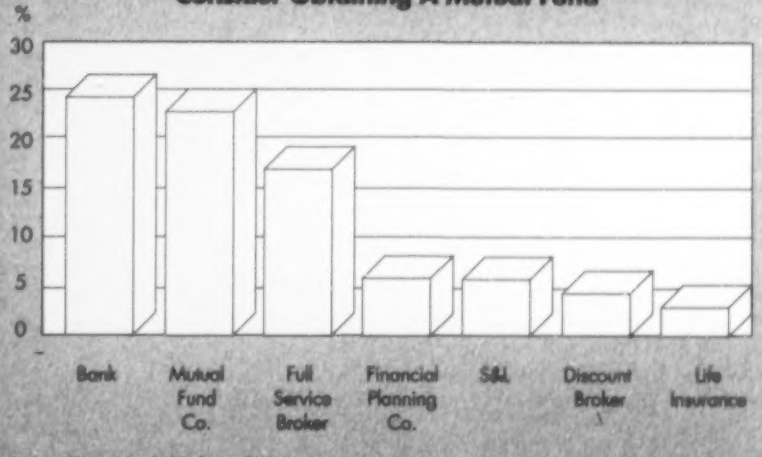
In sum, the nation's larger banks will remain in the mutual fund business and grow. Many smaller banks will not get into the fund management business at all; others will opt to market funds managed by other banks or other providers. If the number of banks does indeed decline to 8,000 in the next eight years, it is likely that 6,000 of them will offer mutual funds in some fashion.

As banks approach the 21st century, they will find a bank mutual fund industry whose assets will no longer be top-heavy with money-market funds. The business will, instead, be propelled by the investment management and trust industry's long-standing and proven expertise in stock and bond investing and its collective determination to provide customers with the broadest possible array of financial products. ◊

Charles B. Landreth is senior vice president of Provident Institutional Management Corp. (PIMC), Wilmington, DE, an affiliate of PNC Financial Corp., the nation's 14th largest bank holding company. PIMC is a fully integrated investment company specializing in fixed-income money management and mutual fund administrative support services to financial institutions and non-financial corporations.

FIGURE 4

Where Customers Say They Would Definitely Consider Obtaining A Mutual Fund



Source: Phoenix-Hecht/Gallup (1989 data)

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